

PAUL MEEK
NOTES FOR FOMC MEETING
JUNE 30, 1982

Open market operations proceeded rather routinely between Committee meetings. To be sure, the Drysdale and Comark affairs, on which I will touch later, proved rather unsettling to the securities markets. But desk operations, though mindful of market sensitivities, continued to be addressed to reserve objectives. Estimates of growth in the monetary aggregates were not far from the Committee's desires during much of the period, and despite unexpected strengthening in the first half of June, both M1 and M2 growth appear on the latest evidence to be close to the Committee's guidelines. Since the M1 weakness of late June will affect reserves only in July, total reserves appear to be coming in about \$150 million above path during the past six weeks. Adjustment borrowing is likely to be about \$250 million on average above the \$800 million adopted by the Committee at its last meeting for drawing up the nonborrowed reserve path.

The implementation of policy during the six weeks was affected by the usual vagaries of reserve forecasting and bank borrowing behavior. In the first half of the period, bank recourse to the discount window was heavier than was consistent with the reserve path, notably in the June 9 week when reserves on the final day fell far short of expected levels. Even so the Federal

funds rate moved down from the 14 1/2 percent plus rate prevailing at the time of the last meeting to about 13 1/2 percent as seemed consistent with the path. The nonborrowed reserve path was adjusted downward by a total of \$61 million in three weeks to allow for the apparent shift in borrowing demand. Subsequently, in the past two weeks, demand for total reserves rose above path, reflecting M1 strength in early June, and technical adjustments were taken to the extent that the intended borrowing gap rose to just over \$1 billion. Full adjustment for technical factors last Friday would have caused the borrowing gap to jump to \$1.3 billion, but this seemed inappropriate on the eve of the Committee's meeting. However, banks did, in fact, borrow heavily over the last weekend as they prepared for the June 30 statement publishing date, so that borrowing will probably be about \$1.5 billion for the week. In the last two weeks, the Federal funds rate rose first to around 14 percent and then above 14 1/2 percent in the past week when preparation for the June 30 statement date pushed up the rate.

In the securities markets yields moved sharply higher over the interval, although there has been a partial reversal in recent days. The pressure exerted by open market operations on the banks was about the same at the end of the period as at the beginning. Initially, as the Drysdale affair broke and the System's more accommodative posture became apparent, Treasury bill rates dropped 50 to 100 basis points and intermediate securities rose in price.

But after the Memorial Day weekend there was an abrupt change in sentiment. Dealers had built up positions in expectations that a sluggish economy would result in declining short-term rates, which would encourage investors to move out to longer maturities. In early June their patience ran out as investors failed to follow their lead to lower yields in the five-year note auction. They began selling aggressively to lighten positions before the onset of heavy Treasury financing in late June and an expected bulge in M1 in July. Accumulating evidence that the recession was bottoming out reinforced the shift to caution. The Drysdale and Comark affairs also kept the market off balance, as successive waves of credit reevaluation contributed to investor caution and dealer retrenchment. The rise in the Federal funds rate in late June also added to market edginess. By June 25 dealer outright holdings of Treasury issues maturing beyond one year had dropped by \$4.9 billion below their May 28 levels, with changes in futures positions providing an offset of roughly \$1.7 billion. The Treasury itself raised \$8.2 billion through coupon sales from mid-May through the end of June.

Passage of the budget resolution brought little lift to the market. The hopes of a major improvement in the budget outlook had been substantially attenuated by the time Congress reached agreement. Market forecasters are now looking for the fiscal year 1983 deficit to range

from \$120 billion upward to \$160 billion or more. Their expectations are that the Treasury will have to raise about \$40 to \$55 billion through sales of marketable issues in the third quarter. The Treasury would not be surprised by a figure in the mid-40's. The Administration's mid-year budget review in about two weeks will bring an update on current estimates. An enlargement of the debt ceiling lasting until the end of September was accomplished, but the Treasury is still seeking legislative authority to resume bond sales.

Market expectations are that the Treasury's market borrowing over the next six months could be close to \$100 billion, compared with \$59 billion in 1981. The New York Bank estimates indicate a \$120 billion borrowing need. Anticipation of the sale this week of \$4 billion each of four-year and seven-year issues contributed to the recent rise in yields. In the event, prices recovered sharply after Tuesday's sale of four-year notes. The seven-year note is now expected to be well bid for tomorrow at 40 basis points below the 15 percent yield being talked about last week. Over the last six weeks, Treasury bill rates have risen by 30 to 90 basis points, while yields on Treasury notes and bonds have risen by 65 to 100 basis points. Corporate and municipal yields also rose considerably with congestion showing up the municipal market on occasion.

The Drysdale collapse, and the more orderly winding down of Comark's business, have exerted a pervasive sobering influence on market participants since mid-May. Dealers' customers have been significantly less willing to supply securities to dealers, which use them in matched-book operations or for short sales. Nonbank dealers operating without a large capital base have also had to pay somewhat higher rates than banks or large dealers for financing their positions. A few dealers have had to deal with rumors about their financial condition at a time when most participants have been scrutinizing carefully the credit standing of those with whom they trade. Not surprisingly, the volume of trading activity has receded, especially in coupon securities. The extent of the backup in Treasury yields doubtless reflects in some degree the increased caution evident in trading among both dealers and customers.

The renewed emphasis on credit quality has also been reflected in the markets themselves. The spread between CD and Treasury bill rates widened by about 50 basis points over the last half of June, although this reflected in part bank eagerness to pre-fund July maturities because of changing rate expectations. Commercial paper rates also rose relative to Treasury bill rates, and rates on A2/P2 paper widened versus those of A1/P1 paper. Despite these ripple effects, the short-term markets have

continued to function well. We feel that the industry has the financial strength, even after recent reverses, to continue to make markets and underwrite Treasury offerings, albeit with wider margins for protection than obtained earlier this year.

In the wake of these disturbances, we have been exploring vigorously the steps that we and the dealers need to take to remedy the deficiencies revealed by the Drysdale and Comark affairs. We are actively pursuing changes in the RP market that would materially reduce the possibility that another Drysdale-type operation could develop. We are also in the process of upgrading the standards we set for Government securities dealers to qualify for the reporting list and a trading relationship with the desk. We are developing plans to strengthen considerably our monitoring of dealers as well as to be more active in developing improved market procedures with the dealers in several areas of mutual concern. Together with our associates in bank supervision, we are also reviewing the operational and credit approval processes used by the major banks to monitor and control their securities clearance operations.

NOTES PREPARED FOR THE FOMC MEETING
June 30 - July 1, 1982

Margaret L. Greene

Mr. Chairman:

Just about the time of your last meeting, a month-long decline of the dollar came to an end; and ever since the dollar has risen strongly, almost without interruption. It reached its peak against most currencies early Monday, the last day for trading before the quarter-end. At that point, the dollar was up 5 percent against sterling and the Canadian dollar, about 7 percent against the German mark and currencies that trade roughly in line with the mark, and 9 percent against the Japanese yen. It advanced even more (14 percent) against the French franc which, along with the Italian lira, was devalued within the EMS over the weekend of June 12-13. With the passing of quarter-end, however, the dollar has eased back 1 1/2 percent across the board by today in generally light trading.

The dollar's strength reflected in some measure a market view that, even after some reassessment during April-May, many of the fundamentals were still favorable to the dollar. There was growing sentiment that the U.S. was making sustainable progress in its fight against inflation as more evidence pointed to a moderation of wage demands in the United States. Also, our balance of payments position looked comfortable enough for this year with strong investment income apparently expected to cushion the effects of any deterioration of the trade account. Moreover, the dollar continued to benefit from a desire for security in the face of political uncertainties. At a time when the international landscape was cluttered with military conflicts around the world, the relatively stable political climate in the

U.S. was attractive to investors from abroad. And, although there continued to be frustration and disappointment over the debate about fiscal policy in the U.S., similar policy controversies were taking place in a number of countries abroad. In Germany, for example, a budget dispute threatened the survival of the Schmidt government and both political parties in that coalition suffered local election setbacks. Also in France, opposition to a post-devaluation austerity package provided the first serious domestic test for the Mitterand Government.

The main factor behind the dollar's gains, however, was a sharp reversal of the widespread expectation, or perhaps hope, that U.S. interest rates would hold steady or decline further. This shift occurred as markets became concerned about the possibility of a renewed money supply bulge in July, the heavy financing needs of the Treasury, the evident strength of private credit demands, and the creditworthiness of counterparties in the market. In effect there developed by mid-June a further sudden increase in the liquidity preference in all dollar markets that happened to coincide, and possibly exaggerate, the pressures that normally appear as banks prepare for their end-June statements and for the heavy buildup of loan rollovers scheduled at that time. The bidding for short-term funds in the Euro-markets and elsewhere put sharp upward pressure on Euro-dollar rates and, to a smaller extent, also on the short and long-term interest rates for other currencies. By early this week the differentials against the mark were, for instance, almost 7 1/2 percentage points for three-month deposits and about 4 1/2 percentage points for 10-year government bonds. As this process developed, the dollar was marked up in trading that was quite choppy and frequently produced abrupt and unexplainable movements in rates.

With the passing of quarter-end pressures and no new development to incite more concern over creditworthiness of counterparties, short-term interest rates have eased back from their peaks. By now, three-month Euro-dollar rates have retreated almost 1 percentage point and the differential vis-a-vis three-month Euro-marks was lower by about 3/4 of a percentage point. But the markets remain vulnerable to any new financial or political development.

During this period that the dollar was rising, a number of currencies came especially under pressure. Among those was the French franc which came under repeated bouts of speculative selling in late May and early June, reflecting market conviction that French economic policy would result in continued inflation and repeated devaluations of the currency within the EMS. And then, over the June 12-13 weekend, the French franc and the Italian lira were devalued, and the mark and Dutch guilder revalued, the total change in the mark-franc parity amounting to 10 percent. This realignment coincided with a number of politically unsettling developments, including the death of the king of Saudi Arabia and a breakdown of the first cease fire in the conflict in Lebanon. In this environment, on Monday June 14, a significant portion of post-realignment speculative reflows from the strong EMS currencies came into dollars instead of francs, and the dollar rose considerably. As the dollar continued to move up in trading in New York, the Desk intervened on behalf of the Federal Reserve and the Treasury jointly to sell \$21 million against German marks and \$9 million against Japanese yen. That the Desk had intervened was publically announced by the Treasury soon after the fact, generating market rumors of concerted central bank action that dampened the dollar's rise for some days thereafter.

Apart from the United States, other central banks intervened during the period to sell a net \$6 billion. Although this represents a sizable amount of intervention, it is smaller than for other periods of equal length in which the dollar was well bid during the past year. By far the largest seller was the Bank of Canada, inasmuch as the Canadian dollar was one of the other currencies to be under especially severe pressure in the face of a strenuous debate over the direction of economic policy there. In addition, the Bank of France intervened in dollars as well as EMS currencies to support the franc at its lower band in that arrangement before the devaluation and has been able to recoup some reserves since. Also, the central banks of Japan and Sweden have been large or regular sellers of dollars. The Bundesbank has intervened in size but only on occasion, generally acting to counter developments other than the pull of U.S. interest rates. The Swiss National Bank also intervened, for the first time this year, to sell dollars as part of a joint operation with the Bundesbank. Meanwhile, most of the authorities abroad, with the possible exception of the French, have apparently postponed further action to ease domestic monetary policy. The Bundesbank did act in mid-June to provide liquidity on a permanent basis by raising its rediscount quotas DM 5 billion; but at the same time transactions to provide liquidity on a temporary basis were allowed to run off.

For the record, perhaps I should mention something about Mexico. Mr. Chairman you referred yesterday to a request by the Bank of Mexico to draw up to \$700 million on its swap line with the Federal Reserve. After consultation with the Bank of Mexico and review by members of the Committee, the request was granted for a month-end drawing to be repaid July 1, but in fact only \$200 million was utilized.

Recommendation

Mr. Chairman, I would like to report to the Committee that the Bank of Mexico has requested a drawing on its swap arrangement with the Federal Reserve for the full \$700 million, not only for month-end window-dressing purposes as agreed on Tuesday, but also to meet a real reserve need during the next several months. You may remember that, shortly after the last FOMC meeting, the Mexican government announced end-May foreign exchange reserves of about \$3.9 billion, somewhat higher than was expected. The increase mainly reflected bridge financing to a "Jumbo" bank loan, and the end-May reserves level has not been sustained in the face of continued capital outflows during June. In addition, the sales of participations in the "Jumbo loan" by syndicate leaders has gone very slowly, limiting Mexico's ability to rollover existing credits and raise the new money needed until the stabilization program begins to show clearer results.

Meanwhile the Mexico authorities have begun to implement the measures envisioned in the stabilization program of April 21. But with the long election process underway, the government has felt constrained from taking some of the more forceful actions included in that program. They are optimistic about the prospect of taking further actions following the election on July 4 and recent public statements by the Finance Minister appear to be preparing the way for more action.

In discussions about this latest request to draw, it has been made clear to us that the Mexican government is willing to assure, in the event the Bank of Mexico is otherwise unable to repay all of its obligations to the Federal Reserve by end October, that the government will have established a conditional credit arrangement with the IMF timely enough to help repay the

drawing. In view of this undertaking by the Mexican government and the present difficult circumstances in Mexico, we expect the Treasury to feel that it is appropriate for the Federal Reserve to respond favorably to the Mexican request at this time. You probably remember that the Treasury, through the Exchange Stabilization Fund, has a swap agreement with the Bank of Mexico that requires Mexico to be eligible to draw under a credit arrangement from the IMF. Once Mexico has agreed with the IMF on an appropriate program, the Treasury has indicated a willingness to participate in a credit to Mexico, including if necessary the provision of funds in order to limit the time in which the Bank of Mexico's swap line with the Federal Reserve is in continuous use.

FOMC Briefing
S. H. Axilrod
6/30/82

During the first half of this year the behavior of the economy in real terms--as indicated by the $1\frac{1}{2}$ percent annual rate of decline in real GNP--was little different from staff projections at the time the Committee initially set this year's targets for the monetary aggregates last February. However, interest rates and prices have behaved somewhat differently from earlier projections. Price increases have been less, with the result that growth in nominal GNP has been about 2 percentage points (annual rate) slower than projected, while interest rates--both short- and long-term--have run a little higher than anticipated. At the same time both narrow and broad measures of the money supply expanded over the first half of this year (measuring from QIV '81 to QII '82) at annual rates from $\frac{1}{2}$ to almost $1\frac{1}{2}$ percentage points in excess of the upper limits of the ranges. These averages would be less through June.

The strength of money aggregates in face of both slower growth in nominal GNP and sustained relatively high short-term interest rates suggests enlarged demands for liquidity on the part of the public, given economic circumstances which have almost certainly generated considerable uncertainty about future income prospects and financial conditions. Another way to assess the meaning of growth in the aggregates thus far this year is to note that growth has been accompanied by fairly substantial declines in the income velocity of both M1 and M2 over the first half of this year. Such declines are often associated with downward pressures on short-term interest rates but this year have been associated with a modest increase in short rates from their average level in the fourth quarter of last year, presumably reflecting strengthened demands for liquidity.

An increase in liquidity demands was associated with surprisingly strong credit growth in the first half of the year. Part of the credit expansion reflected enlarged U.S. Government borrowing, of course, but in addition nonfinancial businesses increased their borrowing at a time when as a group their net need for external funds was apparently declining. While there are gaps in the data, the added borrowing has been accompanied by greatly increased expansion in business's holdings of liquid assets, particularly in the second quarter. It seems some firms may have borrowed to improve their liquid asset positions, particularly firms which might have reason to fear that a tightening in bank lending or commitment policies could reduce their normal access to bank credit. It is also quite probable, of course, that liquid assets were built up by firms who did not borrow to obtain them but rather viewed these assets as a better investment than inventories, given their high return and the uncertain economic outlook.

In view of the behavior of the monetary aggregates in the first half of the year, and associated behavior of interest rates and velocity, the Committee's assessment of the monetary ranges for 1982 might reasonably involve, as noted in the blue book, either maintaining current ranges or raising them. There are three principal arguments for maintaining the ranges: (1) an increase would run excessive risk of casting doubt on the Committee's longer-run intentions to curb inflation, with adverse impacts on whatever emerging tendencies there may be for labor and business to temper wage bargains and pricing decisions; (2) the rise in velocity of M1 consistent with both coming within the ranges this year and encouraging a reasonable economic recovery in the second half is in any event not out of line with past cyclical experience and might be accomplished with little further upward interest rate pressure, particularly as the public willingly begins to work down liquidity built up earlier this year; and (3) Federal fiscal policy is itself stimulative enough to encourage a reasonable economic recovery.

Arguments for raising the range include: (1) a judgment that "announcement" effects on inflationary expectations are not likely to be adverse in a period when plant capacity and labor resources are greatly underutilized; (2) a view that fairly strong demands for liquidity are likely to persevere and work to moderate any cyclical rebound in velocity; and (3) an analysis which suggests that a lower level of interest rates than forecast by the staff would be needed to stimulate private spending, even in face of a tax cut, particularly if reduced inflationary expectations might be restraining the willingness of consumers and also businesses to incur debt.

If the Committee decides to retain the 1982 range, it may wish to consider indicating that actual growth could be expected to be around the upper limits of the ranges or somewhat below. If the ranges were raised, that change itself would probably serve notice that growth near the upper end was being contemplated.

With regard to ranges for 1983, the logic of the situation seems to point either to retaining the existing 1982 ranges or reducing them. The ranges could easily be retained at this stage but possibly with an indication that actual growth within the ranges next year would be expected to be lower than this year--while also noting uncertainties such as those connected with the impact of further deregulation by DIDC, with other possible changes in financial structure (e.g. sweep accounts), and with shifting liquidity demands in an uncertain economic environment. However, a reduction in the 1983 ranges from the existing ones for 1982 would also be consistent with continued economic recovery next year, though quite a modest one, as indicated by the staff's GNP forecast. Growth in the aggregates would be expected to be near the upper ends of slightly reduced

ranges. The odds that a slightly reduced range would be consistent with a stronger performance of real GNP next year than is currently projected by the staff seem fairly small, though, and particularly so of course if progress in slowing price increases is not as rapid as we have estimated.



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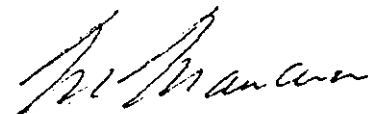
August 3, 1982.

MR. PAUL VOLCKER
CHAIRMAN
BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
20 STREET & CONSTITUTION AVE., N. W.
WASHINGTON, D. C. 20551
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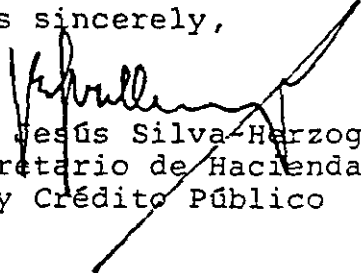
Dear Chairman Volcker:

We are pleased that agreement has been reached on activating August 4, 1982, the swap arrangement between the Banco de Mexico and the Federal Reserve System. In order to bolster market confidence and strengthen Mexico's reserve position, the Government of Mexico in coming weeks will accelerate the implementation of its stabilization program that was announced on April 21 and, as necessary, intensify that program.

The Banco de Mexico intends to repay its drawing as soon as its reserve position permits. The agreed drawing will have a maturity of three months, subject to one additional three-month renewal on mutual agreement. In any event, any and all drawings made under the swap arrangement will be finally liquidated no later than January 31, 1983. The Government of Mexico and Banco de Mexico will take all actions required to meet these obligations including, if necessary to meet the final liquidation date, timely drawings from the International Monetary Fund. Accordingly, if necessary to meet these obligations, the Government of Mexico is prepared to undertake detailed discussions with the International Monetary Fund with a view to establishing an International Monetary Fund program for Mexico in the fall.


Lic. Miguel Mancera
Director General
Banco de México, S. A.

Yours sincerely,


Lic. Jesús Silva-Herzog
Secretario de Hacienda
y Crédito Público



THE SECRETARY OF THE TREASURY
WASHINGTON 20220

August 4, 1982

Dear Paul:

The Federal Reserve System has been requested to agree to an emergency drawing of up to \$700 million by the Bank of Mexico on the Federal Reserve swap arrangement.

I understand that Secretary Silva Herzog has provided you with assurance that Mexico will accelerate and, as necessary, intensify the stabilization program announced on April 21, and has further indicated that if any drawings are outstanding on January 31, 1983, the Government of Mexico will if necessary by that date at the latest have established a conditional IMF credit arrangement designed to correct the Mexican economic and financial situation and to help repay any outstanding swap drawings by January 31, 1983, at the latest. In this connection, the Treasury through the Exchange Stabilization Fund is prepared to participate in credit to Mexico as soon as the IMF agreed to a conditional credit program for Mexico. It is understood that this participation may serve to limit the length of time that the Bank of Mexico's swap arrangement with the Federal Reserve is continuously in use.

Under the present circumstances and with these understandings, agreement to a drawing by the Bank of Mexico on the Federal Reserve appears clearly appropriate.

Sincerely,

A handwritten signature in cursive script that reads "Donald T. Regan".

Donald T. Regan

The Honorable
Paul A. Volcker
Chairman of the Board of
Governors
Federal Reserve System
Washington, D. C. 20551